Richard Isenberg dep. 8/14/2012 (portfolio hedging by institutional traders)

177:24 Q. Well, let's say the trader -- an
177:25 institutional trader has a portfolio of
178:1 RICHARD A. ISENBERG
178:2 instruments that it's responsible for.
178:3 A. Okay.
178:4 Q. What would be in that portfolio?
178:5 A. Whatever -- whatever types of
178:6 securities he's authorized to transact in.
178:7 Q. So it could be passthroughs?
178:8 A. If it's the pass -- yes, if it's
178:9 a passthrough trader, yes.
178:10 Q. Could be specified -- could be
178:11 TBAs?
178:12 A. If it's the TBA trader, yes.
178:13 Q. Could be specified pools?
178:14 A. If it's the specified pool
178:15 trader, yes.
178:16 Q. And it could be CMOs?
178:17 A. If it's one of the agency CMO
178:18 traders, yes.
178:19 Q. So they might have many
178:20 instruments in their inventory; is that
178:21 correct?
178:22 A. Sure.
178:23 Q. And how many might they have? A
178:24 hundred? A thousand instruments?
178:25 MR. MOORE: Object to form.
179:1 RICHARD A. ISENBERG
179:2 THE WITNESS: It varies by the
179:3 type of trader and strategy, but it
179:4 could be hundreds to thousands.
179:5 BY MR. MUNVES:
179:6 Q. So let's say we're talking about
179:7 a passthrough TBA trader.
179:8 A. Okay.

Q. How does he hedge his inventory?

A. Typically, a TBA trader would hedge his inventory either via TBAs, treasuries, interest rate swaps, futures and Euro dollars.

Q. So does that mean the trader is selling short an equivalent amount of those things you just mentioned to offset the long risk on TBAs in his inventory?

A. I don't know what you mean by the term "equivalent amounts."

Q. Well, tell me how the trader would hedge the hypothetical inventory of a thousand passthrough TBAs.

A. Generally, what happens is, you would sit there and try to determine what the duration is of the portfolio and what his

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exposure is as determined, you know, by equivalents.

Like, for a TBA trader, he could sit there and try to determine how long or short he is in ten-year equivalents. And then, you know, once he determines what he believes to be, you know, how long he's short in ten years, he has the choice of -- let's say he's long 50 million ten years, he can go out and sell 50 million ten years, and he would have put on a hedge that is somewhat correlated and somewhat effective.

It doesn't eliminate all of the exposure, but it certainly eliminates a lot of the interest rate exposure.

Q. How would he do that if he were a trader of the specified pool?

A. Similarly, because specified pools would be equated back to TBAs.

Q. And how would he do it for an inventory of agency CMOs?

A. It gets a little bit more complicated there because you have different kinds of exposures -- you have more

complicated exposures in CMOs.

Q. So how would he do it?

A. Well, he would -- generally, what happens is overnight the agency CMO desk runs their exposure through analytics. They come in in the morning. They take a look at what the models tell them their exposure is. They adjust the models -- or they adjust their exposure, sorry, not the models, they adjust their exposure based on known deficiencies in the models and based on, you know, how the market is trading.

And then based on that analysis and them adjusting their exposure, they may or may not adjust their hedges.

Q. You say adjust based on known deficiencies.

What do you mean by known deficiencies?

A. Well, there's -- right now currently, most, if not all, prepaid models in the market do not produce results that the market believes are accurate, that reflect what either true prepayments are or what the

market perceives true prepayments to be. Sorry.

Q. When you say "true prepayments," are we talking about expected duration of the pool of mortgages, such that, for example, 30-year mortgages prepay, most of them prepay

in seven years or eight years or five years? Is that the kind of thing you're talking about?

A. Well, it's -- that's not necessarily what I was talking about, but prepayment affects the duration of your security immensely. Okay?

But what I'm talking about is, your model can sit there and say, you know, this security is going to prepay like, you know, at this particular rate. All right? Where the market believes these types of securities trade at a totally different rate.

Q. You mean prepay at a different rate.

A. Or prepay at a different rate, sorry. That's what I meant, yes.

Q. So the trader would then take

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the current prepayment rate that he had determined from the market and plug that into the prepayment model instead of the rate that was in there already?

A. He could or he could just adjust the results that the model told him based on, you know, how he knows it's going to trade.

Q. And how would he know how much to adjust the model?

A. Experience. That's what he gets paid for.

Q. But if each CMO is a different structure, how would he know how a small change to the prepayment model would affect different CMOs?

A. Well, what I said is, each CMO is generally a unique structure, but tranches of CMOs, a lot of them are very similar.

183:20 Q. But if he doesn't find a similar
183:21 one, then he makes the adjustment to
183:22 prepayment rate -- if he doesn't find a
183:23 similar tranche, he can also change the
183:24 prepayment speed and the prepayment model and
183:25 rerun the valuation in The Yield Book; is that
184:1 RICHARD A. ISENBERG
184:2 correct?
184:3 A. There could be several things
184:4 that he could do. What he could do is he
184:5 could actually **Redacted**

Okay?
184:9 Or he could sit there -- The
184:10 **Redacted**
.
184:12 Q. And then you would rerun the
184:13 valuation **Redacted**
.
184:15 A. You would sit there, probably
184:16 put in **Redacted** , and you would rerun
184:17 it, and it would either generate a new yield
184:18 or a new price.
184:19 Q. Depending upon what you were
184:20 looking for.
184:21 A. Correct.
184:22 Q. So the trader who is trading
184:23 CMOs looks at the market, determines the
184:24 prepayment speed, determines whether he thinks
184:25 the model is -- the prepayment model
185:1 RICHARD A. ISENBERG
185:2 accurately reflects the prepayment speed and
185:3 can make adjustments and can then rerun the
185:4 model after he's made the adjustments.
185:5 A. That's typically what he does.